

## TAX SHELTER PENALTIES: ARE THEY DIVISIBLE? OR DOES THE TAXPAYER HAVE TO PAY THE BALANCE BEFORE LITIGATING?

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The Internal Revenue Service (“I.R.S.” or “Service”), in reaction to the recent legislation prohibiting the aggressive promotion of tax shelter products, has heightened its scrutiny and allocated its resources to the examination and litigation of tax shelters and their promoters.<sup>1</sup> Because of this increased activity in the area of tax shelter promoter litigation, the size of the overall penalties involved, and because the United States Tax Court (“Tax Court”) is not an available forum for their litigation, the question of the divisibility of tax shelter penalties for purposes of jurisdiction in federal district court is inevitable.

This article analyzes the divisibility of the penalties described in I.R.C. §§ 6700, 6707 and 6708 by comparing them to taxes that are currently considered divisible, such as employment taxes, 100% penalties, and excise taxes. It then proposes that these tax shelter promoter penalties should be considered divisible for purposes of jurisdiction in federal district court, and why they should be so treated.

## I. INTRODUCTION

The Tax Court, federal district court, and the Court of Claims are the three forums available for a taxpayer to contest his federal tax liability.<sup>2</sup> However, in 1991, one commentator noted that approximately 95% of federal tax cases are tried in Tax Court.<sup>3</sup> Tax litigants overwhelmingly prefer the Tax Court because it is the only forum in which taxpayers do not have to pay the full amount of his or her tax assessment before challenging its validity.<sup>4</sup>

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1. See Auditor Independence and Tax Shelters Act, H.R. 3599, 108th Cong. (2003) (titled, “A bill to prevent corporate auditors from providing tax shelter services to their audit clients”); see also Regulations Governing Practice Before the Internal Revenue Service, 68 Fed. Reg. 75186, 75187–88 (proposed Dec. 30, 2003 (to be codified at 31 C.F.R. pt. 10) identifying disclosures required to be made at the beginning of marketed tax shelter opinions and requiring practitioners with oversight responsibility to take “reasonable steps” to ensure the firm has adequate procedures in effect to comply with the disclosure requirements).

2. See I.R.C. §§ 7402 (2000); see also *United States v. Emery, Byrd, Thayer Realty Co.*, 237 U.S. 28, 30 (1915).

3. Deborah A. Geier, *The Tax Court, Article III, and the Proposal Advanced by the Federal Courts Study Committee: A Study in Applied Constitutional Theory*, 76 CORNELL L. REV. 985, 987 n.8 (1991) (citing Theodore Tannenwald, Jr., *The Tax Litigation Process: Where It Is and Where It Is Going*, 44 Rec. A. B. City of N.Y. 825, 827 (1989)).

4. Shoshana Charlop, *Recovering Litigation Costs and Attorneys’ Fees After the Technical and Miscellaneous Revenue Act of 1988*, 12 CARDOZO L. REV. 165, 170 n.25 (1990). The Tax Court is established under Article I of the Constitution of the United States. I.R.C. § 7441 (2000). Prior to its establishment as an Article I court, the Tax Court was an independent executive agency named the Board of Tax Appeals. Leslie Book, *The IRS’s EITC Compliance Regime: Taxpayers Caught in the Net*, 81 OR. L. REV.

Because the United States Constitution does not grant the Tax Court jurisdiction over tax shelter penalties, they must be litigated in a federal district court or the Court of Claims.<sup>5</sup> The taxpayer must first pay the tax and penalties before it can proceed in one of these two forums.<sup>6</sup> Because these penalties often range in the hundreds of thousands of dollars divisibility becomes an important issue for those taxpayers who wish to contest the validity of the assessment.

## II. OVERVIEW OF DIVISIBILITY AND ITS IMPORTANCE

Generally, a taxpayer must pay the full amount of an income tax assessment before he may challenge its validity in federal district court in an action under 28 U.S.C. § 1346(a)(1).<sup>7</sup> This general rule comes from the Supreme Court's decision in *Flora v. United States*.<sup>8</sup> In two footnotes to its opinion, however, the Court in *Flora* articulated the existence of a "divisible assessments" exception to its jurisdictional rule.<sup>9</sup>

Under this exception a taxpayer does not have to pay the full amount of the tax to challenge its validity in federal district court.<sup>10</sup> Divisible assessments have been defined as those that are "taxes or penalties that are seen as merely the sum of several independent assessments triggered by separate transactions."<sup>11</sup> The Eighth Circuit in *Steele v. United States*, formally recognized

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351, 376 n.82 (2002). Since its inception, the Tax Court's primary function has been to provide taxpayers an opportunity to litigate tax disputes against the IRS without first paying the disputed amount. Leandra Lederman, *Equity and the Article I Court: Is the Tax Court's Exercise of Equitable Powers Constitutional?*, 5 Fla. Tax Rev. 357, 366 (2001).

5. See 28 U.S.C. § 1346(a)(1) (2000). As an Article I court, the Tax Court's jurisdiction is limited to those areas specifically granted by statute. See U.S. CONST. art I, § 8; I.R.C. §§ 7441-42 (2000). The majority of Tax Court cases arise under deficiency jurisdiction, which allows the Tax Court to review deficiencies asserted by the IRS for additional income, estate, gift, or self-employment taxes or special excise taxes imposed on taxpayers under Chapters 41-44 of the Code. I.R.C. § 6512 (2000). In a notice of deficiency, the IRS must notify the taxpayer that a tax is due, the type of tax, the tax period, and that the taxpayer has a right to bring suit before assessment and payment in the Tax Court. § 7522. The taxpayer then has 90 days (150 days if the notice is addressed to a person outside the United States) from the date of the notice of deficiency to petition the Tax Court. § 6213(a). The 1998 Restructuring Act imposed a requirement that the notice of deficiency state the latest date for the taxpayer to file the Tax Court petition. I.R.S. Restructuring & Reform Act, Pub. L. No. 105-206, § 3463(a) (1998). Though not codified, this section of the statutes at large has the force of law. 1 U.S.C. § 112 (2000).

6. *Flora v. United States*, 357 U.S. 63, 75 (1958).

7. *Id.*

8. *Flora v. United States*, 362 U.S. 145, 149-51 (1960).

9. *Id.* at 171 n.37, 175 n.38.

10. *Korobkin v. United States*, 988 F.2d 975, 976 (9th Cir. 1993).

11. *Id.*

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the effect of these two footnotes by ruling that “the full payment rule is not applicable to an assessment of divisible taxes.”<sup>12</sup> Taxes that have been found to be, and are now generally accepted as divisible include excise and employment taxes, and 100% penalties imposed by I.R.C. § 6672.<sup>13</sup>

Whether a tax is divisible depends on the interpretation of the term “divisible assessments” with respect to such tax. This article analyzes the meaning of “divisible assessments” with respect to the tax shelter penalty provisions of I.R.C. §§ 6700, 6707 and 6708, to determine if they are in fact divisible for purposes of jurisdiction in federal district court.

### III. I.R.C. § 6700

The section 6700 promoter penalty applies to a promoter who makes a false or fraudulent statement with respect to (1) the allowability of any deduction or credit, (2) the excludability of any income, or (3) the securing of any other tax benefit by reason of holding an interest in the entity.<sup>14</sup>

Prior to its amendment in December 1989, the text of section 6700 did not address whether each activity entered into by a tax shelter promoter would be treated as a separate activity for purposes of computing the penalty.<sup>15</sup> As explained below, Congress added such clarifying language for years after 1989.<sup>16</sup> Therefore, for jurisdictional purposes, the divisibility of penalties relating to pre-1990 transactions may be different than those relating to post-1990 transactions.

For refund claims filed on or after December 19, 1989, a taxpayer need only pay 15% of the penalty to be eligible to bring an action in federal district court or the Court of Federal Claims for a refund of the full assessment.<sup>17</sup> Because of this special provision, the courts have not examined divisibility of the I.R.C. § 6700 penalty on post-1989 transactions for purposes of jurisdiction in these courts.<sup>18</sup>

Therefore, all of the case law dealing with divisibility of the

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12. *Steele v. United States*, 280 F.2d 89, 90 (8th Cir. 1960).

13. *See Boynton v. United States*, 566 F.2d 50, 54 n.5 (9th Cir. 1977); *Flora*, 362 U.S. at 175 n.38; *Steele*, 280 F.2d 89.

14. I.R.C. § 6700(a)(2)(A) (2000).

15. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7734(a)(1)-(3).

16. *See Omnibus Budget Reconciliation Act § 7734(b)*; *see also* I.R.C. § 6700.

17. I.R.C. § 6703(c) (2000).

18. *See, e.g., Sage v. United States*, 908 F.2d 18, 21-22 (5th Cir. 1990).

section 6700 penalty relates to pre-1990 transactions.<sup>19</sup> However, the majority of these cases did analyze divisibility, not to determine whether jurisdiction was proper, but instead to determine whether calculation of the penalty was correct (in the case of divisibility by transaction) or whether the notice of deficiency was sufficient (in the cases of divisibility by tax period).<sup>20</sup> These pre-1990 cases found the section 6700 penalty not divisible, annually or transactionally.<sup>21</sup> The following analysis of these cases will indicate that even though all existing case law (relating to pre-1989 transactions) finds section 6700 to be indivisible, there is, in fact, a strong argument that the 6700 penalty is divisible for post-1989 transactions.

Even though the taxpayer now need only pay 15% of the penalty to file for a refund in federal district court, divisibility is still extremely relevant given the penalty dollar amounts and the volume of transactions entered into by many promoters.<sup>22</sup> For example, it is not uncommon for a promoter to sell thousands of tax shelters. For illustrative purposes, assume a tax shelter promoter sold 1000 shelters that were required to be registered. The failure to register penalty at \$1,000 per transaction, would total \$1,000,000.<sup>23</sup> Fifteen percent of the total penalty is \$150,000. If the penalty were considered divisible, the taxpayer need only pay \$1,000 (instead of \$150,000) to challenge its validity in federal district court. This is quite an incentive for a taxpayer to argue the penalty is divisible.

A. *Case law and the Service's interpretations of pre-1990 I.R.C. § 6700*

1. General Divisibility of Section 6700

The predecessor to the current version of I.R.C. § 6700 provided that the penalty under I.R.C. § 6700 was "equal to the greater of \$1,000 or 20 percent [10% before 1984] of the gross income derived or to be derived by such person from such activity."<sup>24</sup> Under this statute, the Service argued that it was entitled to impose a penalty of \$1,000 for each investor that

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19. *Id.*

20. *Id.*

21. *Id.*

22. I.R.C. § 6703(c).

23. § 6700(a).

24. § 6700.

invested in an entity, plan, or arrangement.<sup>25</sup> Initially, the federal district courts were split in their interpretations of section 6700's divisibility language, with some of their decisions favoring the Service's multiple assessment argument.<sup>26</sup> The Federal Courts of Appeals, considering the issue held that the \$1,000 was merely an aggregate minimum penalty and not a penalty to be imposed on each transaction.<sup>27</sup> In light of these appellate court decisions, in 1989 the Service issued Litigation Guideline Memorandum ("LGM") TL-27 stating that it would no longer pursue the \$1,000 per sale interpretation of the penalty.<sup>28</sup> Thus, the Service's litigation position with respect to section 6700, is that the penalty is calculated as the greater of 20% of gross income derived from all promotional activities up to the date of assessment, or \$1,000 minimum for all promotional/sales activities up to the date of assessment.<sup>29</sup>

## 2. Application of General Divisibility Analysis of § 6700 for Jurisdictional Purposes

Only one circuit court case, *Noske v. United States*, has examined divisibility of the 6700 penalty for purposes of jurisdiction in a refund suit in federal district court.<sup>30</sup> The Eighth Circuit based its divisibility analysis on the analysis used in *Gates v. United States*.<sup>31</sup> In *Gates* it addressed both whether the section 6700 is divisible by transaction, and whether it is assessable on an annual basis.<sup>32</sup> *Gates*, however, did not look at these issues to determine the district court's jurisdiction, but instead to determine the correct computation and amount of the penalty.<sup>33</sup> The court in *Gates* determined that the penalty was not divisible by transaction, and also that the assessment of such penalty should be made on a one-time basis, rather than annually.<sup>34</sup>

Therefore, even though *Gates* did not address divisibility for

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25. See *Spriggs v. United States*, 660 F. Supp. 789, 790 (E.D. Va. 1987), *aff'd*, 850 F.2d 690 (4th Cir. 1988).

26. Compare *id.* (rejecting Service's argument), with *Hill v. United States*, 720 F. Supp. 95 (W.D. Mich. 1989) (upholding the Service's argument).

27. See *Gates v. United States*, 874 F.2d 584 (8th Cir. 1989); *Bond v. United States*, 872 F.2d 898 (9th Cir. 1989); *Spriggs*, 660 F. Supp. 789.

28. Litigation Guideline Memorandum, I.R.S. (July 25, 1989).

29. *Gates*, 874 F.2d at 587.

30. 911 F.2d 133 (8th Cir. 1990).

31. *Id.* at 135; *Gates*, 874 F.2d 584.

32. *Gates*, 874 F.2d at 586-88.

33. *Id.*

34. *Id.* at 586.

jurisdictional purposes, the Eighth Circuit in *Noske* used the *Gates* analysis to analyze divisibility for just that purpose.<sup>35</sup> The *Noske* court agreed that the section 6700 penalty was not divisible.<sup>36</sup> However, it allowed jurisdiction for a partial payment because before *Gates* was decided the section 6700 penalty was a divisible penalty.<sup>37</sup> It did, however, comment that the *Gates* non-divisibility holding should be applied prospectively to determine subject matter jurisdiction in federal district court.<sup>38</sup>

The *Noske* court's comment appears unfounded. If the penalty is divisible on a transactional basis to determine correct computation and amount of the penalty, it should be considered divisible for purposes of subject matter jurisdiction in refund suits in federal district court. As shown below, for transactions occurring after December 31, 1989, the section 6700 penalty is a divisible penalty, and should be treated as such for jurisdiction purposes in refund litigation purposes.<sup>39</sup>

#### B. Current I.R.C. § 6700

In 1989, Congress substantially changed I.R.C. § 6700 to its current version.<sup>40</sup> The current version applies to activities after December 31, 1989, and therefore applies to the years currently under question by the Service.<sup>41</sup> As previously stated, I.R.C. § 6700 now provides for a penalty "equal to \$1,000 or, if the person establishes that it is lesser, 100 percent of the gross income derived (or to be derived) by such person from such activity."<sup>42</sup> The change also added the following language "[f]or purposes of the preceding sentence, activities described in paragraph (1)(A) with respect to each entity or arrangement shall be treated as a separate activity and participation in each sale described in paragraph (1)(B) shall be so treated."<sup>43</sup> This language clarifies that the penalty is the lesser of 100% of the gross income derived from such activity or \$1,000 per entity or arrangement.<sup>44</sup> The legislative history for the current version of I.R.C. § 6700 states, "[t]he committee made these modifications

35. *Noske*, 911 F.2d at 134–35.

36. *Id.* at 136–37.

37. *Id.*

38. *Id.* at 137.

39. *See infra* Part I–B.

40. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101–239, § 7734(a)(1)–(3).

41. Omnibus Budget Reconciliation Act § 7734(b).

42. I.R.C. § 6700(a)(2)(B) (2000).

43. § 6700(a)(2)(B).

44. § 6700(a)(2)(B).

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because the courts have differed in their interpretations of the provisions of the present law.”<sup>45</sup> Furthermore, “[t]he committee believes [the] modifications will eliminate confusion for cases arising in the future.”<sup>46</sup> The change in the law along with its legislative history leaves no room for doubt that the \$1,000 penalty is imposed on each transaction and not each activity.

Even though the section 6700 penalty is not separately assessed for each transaction, it should still be considered divisible based on the arguments analyzed in the section below on the divisibility of sections 6707 and 6708. In summary, since the current version of the law makes the section 6700 penalty divisible by transaction, it should be considered divisible for jurisdictional purposes in refund litigation in federal district court.

## IV. I.R.C. §§ 6707 AND 6708

Under I.R.C. § 6707, the penalty for failure to register a tax shelter is the greater of (1) \$500 or (2) 1% of the aggregate amount invested in the tax shelter.<sup>47</sup> The same penalties for failing to register a tax shelter apply to those persons who file false or incomplete information with the Secretary with regard to such tax shelters.<sup>48</sup>

In the case of a tax shelter offered under conditions of confidentiality, the penalty for failure to register is the greater of (1) 50% of fees paid to the tax promoter or (2) \$10,000.<sup>49</sup> If the registration requirement is intentionally disregarded then “75 percent” is substituted for “50 percent.”<sup>50</sup>

Under I.R.C. § 6708, the penalty for any person who fails to comply with the investor list requirements of section 6112 is \$50 for each person with respect to whom there is a failure, up to a maximum of \$100,000 for any calendar year.<sup>51</sup>

Unlike I.R.C. § 6700, there is no special rule allowing the taxpayer to pay 15% of the penalty for I.R.C. §§ 6707 or 6708.<sup>52</sup> Therefore, unless the taxpayer can argue that the penalty is divisible, he must pay the full amount to be eligible to file a claim

45. H.R. REP. NO. 101-247, at 1397 (1989), *reprinted in* 1989 U.S.C.C.A.N. at 2867.

46. *Id.*

47. I.R.C. § 6707(a)(2) (2000). The Tax Reform Act of 1986 eliminated the \$10,000 cap for tax shelters offered for sale after October 22, 1986. *Id.*

48. I.R.C. § 6707(a)(1)(B).

49. § 6707(a)(3)(A).

50. § 6707(a)(3)(A).

51. § 6708(a).

52. *See* §§ 6700, 6707, 6708.



for refund and bring an action in federal district court or the Court of Federal Claims.<sup>53</sup>

In its *Flora* decision, the Supreme Court provided the general rule that a taxpayer must pay the full amount of an income tax assessment before he may challenge its validity in federal district court in an action under 28 U.S.C. § 1346(a)(1).<sup>54</sup> However, in two footnotes to its opinion, the Court in *Flora*, articulated a “divisible assessments” exception to its jurisdictional rule.<sup>55</sup> Under this exception a taxpayer does not have to pay the full amount of the tax to challenge its validity in federal district court. Divisible assessments have been defined as those that are “taxes or penalties that are seen as merely the sum of several independent assessments triggered by separate transactions.”<sup>56</sup> The Eighth Circuit in *Steele v. United States* formally recognized the effect of these two footnotes by ruling that “the full payment rule is not applicable to an assessment of divisible taxes.”<sup>57</sup> Taxes that have been found to be and are now generally accepted as divisible include excise and employment taxes, and 100% penalties imposed by I.R.C. § 6672.<sup>58</sup>

To determine whether penalties assessed under I.R.C. §§ 6707 or 6708 are divisible, we must look to the nature of the types of taxes that are already treated as divisible, and why they are so treated. In addition, it is important to analyze why taxes or penalties considered not to be divisible are so treated. This analysis is key, because it is necessary to determine whether, in order to be divisible, the penalty itself, or the underlying tax on which such penalty is based, must be (a) separately assessed as to each separate transaction or person, or (b) if it need be only separable.

#### A. *Comparison of Other Divisible Taxes to I.R.C. §§ 6707 and 6708 Penalties*

##### 1. Employment Tax and Trust Fund Recovery Penalty (I.R.C. § 6672)

Employment taxes and trust fund recovery penalties are considered divisible taxes for purposes of federal district court

53. See §§ 6700, 6707, 6708.

54. *Flora v. United States*, 362 U.S. 145, 177 (1960).

55. *Id.* at 171 n.37, 175 n.38.

56. *Korobkin v. United States*, 988 F.2d 975, 976 (9th Cir. 1993).

57. 280 F.2d 89 at 90.

58. See *e.g.*, *Church of Scientology of Colo. v. United States*, 499 F. Supp. 1085 (D. Colo. 1980).

jurisdiction for refund litigation.<sup>59</sup> An analysis of these taxes and penalties will show that their divisibility is based on the fact that both are separable based on amounts calculated for each employee, even though they are not separately assessed with respect to any single employee or transaction.<sup>60</sup>

This section analyzes the divisibility of both employment taxes and the trust fund recovery penalty by analyzing case law relating to the trust fund recovery penalty tax, because almost all of the litigation in this area deals with jurisdiction in such trust fund penalty cases, yet analyzes the divisibility of both types of tax.

#### (a) Divisibility of § 6672 Penalty

When a taxable entity fails to pay the federal employment taxes withheld from its employees' wages, a portion of the taxes may be assessed personally against employees responsible for making financial decisions for the taxpayer company ("responsible persons").<sup>61</sup> These assessments are called "trust fund recovery penalties" because an employer must hold such amounts withheld in a special trust fund until it pays the amounts to the United States.<sup>62</sup>

The cases that have interpreted the divisibility of the I.R.C. § 6672 penalty have attributed such divisibility to the nature of the underlying tax to which it relates, I.R.C. § 3501 payroll tax.<sup>63</sup> All of these cases agree that payroll taxes are divisible, but present two conflicting lines of reasoning for such divisibility.<sup>64</sup>

One line of cases reasons that payroll taxes are divisible because they are assessed separately for each employee.<sup>65</sup> The other line of cases finds payroll taxes to be divisible because they represent the *aggregate* of taxes due on multiple transactions or an accumulation of *separable* assessments.<sup>66</sup>

59. *Steele*, 280 F.2d at 89.

60. *Id.*

61. Timothy S. Kingcade, *Trust Fund Recovery Penalty: Personal Liability For an Employer's Failure to Pay Its Employees' Withholdings to the IRS*, 70-OCT Fla. B.J. 60, 61, 63 (1996) (citing 26 U.S.C. §§ 3102, 3402 (2000)).

62. I.R.C. § 7501(a) (2000); see also Kingcade, *supra* note 61, at 60.

63. See e.g., *Korobkin*, 988 F.2d at 976; *Weston v. United States*, No. CS-95-0113-FVS, 1996 WL 233779, \*3 (E.D. Wa. 1996); *Boynton v. United States*, 566 F.2d 50, 51-52 (9th Cir. 1977); *Rocovich v. United States*, 933 F.2d 991, 995 (Fed. Cir. 1991).

64. *Korobkin*, 988 F.2d at 976; *Weston*, 1996 WL 233779 at \*3; *Boynton*, 566 F.2d at 52; *Rocovich*, 933 F.2d at 995.

65. *Korobkin*, 988 F.2d 975; *Weston*, 1996 WL 233779 at \*3.

66. *Boynton*, 566 F.2d at 52; *Rocovich*, 933 F.2d at 995.

A separate analysis of each of the two divisibility theories indicates that the first theory, separate assessment, is flawed, while the second theory, separable assessment, more properly describes the nature of payroll taxes and the correct reasoning for why these taxes are divisible.

The first case in which the “separate assessment” theory surfaced was *Korobkin v. United States*.<sup>67</sup> Although the *Korobkin* case dealt with the divisibility of I.R.C. § 6700 tax shelter penalties, it used a section 6672 employment tax penalty divisibility comparison to support its opinion that section 6700 penalties are not divisible.<sup>68</sup> The court’s conclusion that divisible penalties must arise from separate assessments appears to stem from its misinterpretation of a statement found in the *Boynton v. United States* opinion.<sup>69</sup> Citing *Boynton*, *Korobkin* states that “payroll taxes can be divisible, because they’re assessed separately for each employee.”<sup>70</sup> The *Boynton* opinion did not discuss separate assessment, but instead found the 6672 penalty divisible based on the theory that “section 6672 assessments represent an accumulation of *separable* assessments for each employee from whom taxes were withheld” [emphasis added].<sup>71</sup> Nevertheless, the *Korobkin* court’s misstatement was solidified further by the opinion in *Weston v. United States* where a federal district court found the 6672 penalty divisible based on the *Korobkin* court’s misunderstanding that payroll tax, as 6672’s underlying tax, is separately assessed for each employee.<sup>72</sup>

#### (b) Divisibility of Employment Tax Assessment

It is not clear whether the *Korobkin* court’s interpretation that payroll taxes are separately assessed referred to the fact that the payroll tax is assessed separately on the account of the employer or each of the employees.<sup>73</sup> An analysis of the Service’s process for assessing payroll taxes shows that in neither case is payroll tax, as a payroll tax, assessed separately on either the employer or the employee.<sup>74</sup>

Payroll taxes are collected by and assessed on the employer as described below. Generally, employers who withhold income

67. *Korobkin*, 988 F.2d at 976.

68. *Id.* at 977.

69. *Boynton*, 566 F.2d at 52.

70. *Korobkin*, 988 F.2d at 976.

71. *Boynton*, 566 F.2d at 52.

72. *Weston*, 1996 WL 237379 at \*3.

73. *Korobkin*, 988 F.2d at 976–77.

74. Treas. Reg. § 31.6011(a)-1 (2004).

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and social security taxes file Form 941, Employer's Quarterly Federal Tax Return.<sup>75</sup> Amounts withheld must be deposited on a more frequent basis with a financial institution qualified as a depository for federal taxes.<sup>76</sup> However, the amounts deposited are not assessed against the employer until the quarterly Form 941 is filed.<sup>77</sup> At that time, the Service makes a single assessment against the employer of the full amount reported on the Form 941.<sup>78</sup> Separate assessments against the employer are not made with respect to each employee to whom the withholding relates.<sup>79</sup>

In addition, payroll taxes are not separately assessed against any employee from whom they are withheld.<sup>80</sup> Tax is assessed against an employee, as a taxpayer, when such employee files his Form 1040, U.S. Individual Income Tax Return.<sup>81</sup> At that time, the Service assesses the amounts shown on the taxpayer's 1040, not the amount withheld by the employer.<sup>82</sup> The amount withheld by the employer is not relevant to the determination of the amount assessed.<sup>83</sup>

This simple analysis of the law and procedures for employment tax assessment makes it apparent for employment tax assessment that the correct divisibility analysis is the one found in *Boynton*.<sup>84</sup> Payroll taxes and accompanying 6672 penalties are an accumulation of separable assessments, but are not separately assessed on either the employer or the employees from whose wages these amounts are withheld.<sup>85</sup>

## 2. Excise Taxes

### (a) Introduction

Generally, taxpayers who participate in certain transactions

75. *Id.* § 31.6011(a)-1(a).

76. I.R.C. § 6302(c).

77. § 6201(a)(1).

78. § 6201(a)(1). The IRS Master File Code Index, which provides codes to record every action taken by the IRS on a taxpayer's account, indicates that Form 941 taxes are assessed under Code 150.U.S. TREAS., REFERENCE NO. 091402, DUPLICATE FORM 941 RETURN FILINGS (1998). Code 150 provides that the amount shown on the taxpayer's return is assessed when such return is filed. *Id.*

79. I.R.C. § 6201(a)(1).

80. Treas. Reg. § 31.6011(a)-1(d)(2).

81. *Id.*

82. Treas. Reg. § 301.6201-1(a)(1) (2004).

83. *Id.*

84. *Boynton*, 566 F.2d at 52.

85. *Id.*

or activities are required to pay excise taxes and file Form 720 on a quarterly basis.<sup>86</sup> Excise taxes are specialty taxes imposed on those engaging in certain types of activities.<sup>87</sup> These taxes are assessed on the taxpayer as described below. An analysis of the Service's process for assessing excise taxes shows that an excise tax is not assessed separately on each transaction, but is a single assessment, based on an aggregation of transactions.<sup>88</sup>

(b) Automatically due and payable

Excise taxes are automatically due and payable by the taxpayer upon engaging in certain activities or transactions.<sup>89</sup> Generally, a taxpayer will owe excise taxes if it manufactures or sells certain products; operates certain kinds of businesses; or uses various kinds of services, facilities, or products.<sup>90</sup> A taxpayers must file Form 720 for each calendar quarter and year-end to report their federal excise tax liability by employer identification number.<sup>91</sup> The federal excise taxes reported on Form 720 consist of several broad categories, including the following taxes: environmental taxes; communications and air transportation taxes; fuel taxes; tax on the first retail sale of heavy trucks, trailers, and tractors; luxury tax on passenger cars; and manufacturers' taxes on the sale or use of a variety of different articles.<sup>92</sup> Each of these separate activities and transactions gives rise to an excise tax liability.<sup>93</sup> Nevertheless, a taxpayer's liability is reported as a single liability based on an accumulation of transactions and activities.<sup>94</sup>

Excise tax amounts due and payable each quarter must be deposited on a more frequent basis with a financial institution qualified as a depository for federal taxes.<sup>95</sup> The amounts deposited are not assessed against the taxpayer until the quarterly Form 720 is filed.<sup>96</sup> At that time, the Service makes a single assessment against the taxpayer of the full liability

86. Treas. Reg. § 40.0-1(a) (2004); Treas. Reg. § 40.6011(a)-1(a) (2004).

87. Treas. Reg. § 40.0-1(a).

88. *Auto-Ordinance v. United States*, 14 Cl. Ct. 295, 299 (Cl. Ct. 1988).

89. I.R.S. Instructions for Form 720, at 3-6 (2004).

90. *Id.*

91. *Id.* at 1.

92. *Id.* at 3-5.

93. *Id.* at 1-5.

94. *Id.* at 8.

95. *Id.* at 7; I.R.C. § 6302(c) (2000).

96. I.R.S. Instructions for Form 720, at 1.

amount reported on the Form 720.<sup>97</sup>

(c) Divisible for refund purposes

Excise taxes are considered divisible taxes for purposes of refund litigation.<sup>98</sup> The statutes and cases all clearly articulate that the taxpayer must pay the tax and sue for a refund where excise taxes are involved.<sup>99</sup> An analysis of excise taxes will show that their divisibility is based on the fact that they are separable based on the amounts calculated for each transaction or event.<sup>100</sup>

The cases that have interpreted the divisibility of excise taxes have attributed such divisibility to the nature of the underlying transaction or event that gives rise to the tax obligation.<sup>101</sup> Such cases reason that excise taxes are divisible because they represent the aggregate of taxes due on multiple transactions or an accumulation of separable assessments on separate events.<sup>102</sup>

*Tysdale v. United States* was the first case to examine the applicability of the “full payment rule” to excise taxes already assessed, but not yet paid.<sup>103</sup> The plaintiff, Tysdale, requested a refund of federal excise taxes already paid and federal excise taxes assessed, but not paid.<sup>104</sup> The defendant, the government, alleged that the federal district court had no jurisdiction to facilitate an abatement of assessed, yet unpaid excise taxes.<sup>105</sup> In finding for the taxpayer, the Court concluded it did in fact have the jurisdiction to abate unpaid taxes.<sup>106</sup> In so finding, the court recognized as undisputed that they had jurisdiction over the refund claim for excise taxes already paid citing *Flora* and stating that the amount of an excise tax is separable as to each transaction.<sup>107</sup> Turning to jurisdiction for the abatement, the *Tysdale* court found “a thorough search has failed to reveal any case in which the relief asked by plaintiff has been granted by a Federal District Court.”<sup>108</sup> The court, again citing *Flora*, held

97. *Id.* at 8; Treas. Reg. § 301.6201-1(a)(1) (2003).

98. *Jones v. Fox*, 162 F. Supp. 449, 455 (D. Md. 1957).

99. *Tysdale v. United States*, 191 F. Supp. 442, 443 (D. Minn. 1961) (citing *Flora*, 362 U.S. at 175 n.38).

100. *Id.*

101. *Flora*, 362 U.S. at 171 n.37 (1960).

102. *Id.* at 175 n.38.

103. *Tysdale*, 191 F. Supp at 442.

104. *Id.*

105. *Id.*

106. *Id.* at 443.

107. *Id.*; *Flora*, 362 U.S. at 175, n.38.

108. *Tysdale*, 191 F. Supp at 443.

that the statutes and cases were all very clear that the taxpayer must pay the tax and sue for a refund for excise taxes.<sup>109</sup> The court further opined “the taxpayer is not required to pay the entire amount of the assessed taxes as a condition precedent to commencing action.”<sup>110</sup> This concept of partial payment was analyzed and supported by other courts.<sup>111</sup>

The *Grain Belt* court understood *Tysdale* and *Flora* “to indicate only that when there is a deficiency assessment for excise taxes, a part of which have been paid, that the taxpayer is not precluded from suing for a refund of that portion of the tax that has been paid, despite the fact that the assessment is for a single amount which is larger than the payment made by the taxpayer.”<sup>112</sup> As the court stated “This result stems from recognition by the courts that an excise tax is separable as to each transaction, so that the government may not lump together a number of taxable transactions and require that the aggregate amount be paid before any suit may be maintained.”<sup>113</sup>

Excise taxes are accepted as divisible amounts because the single assessment made is the aggregate of amounts due with respect to excise tax obligations.<sup>114</sup>

#### B. I.R.C. §§ 6707 and 6708

I.R.C. §§ 6707 and 6708 are divisible in the same manner as employment and excise taxes, and therefore should be considered divisible for purposes of jurisdiction of refund claims in federal district court.<sup>115</sup>

The section 6707 penalty is not assessed separately for each tax shelter that is not registered.<sup>116</sup> It is instead calculated at 1% of the aggregate amount invested in a tax shelter, or \$500 per tax shelter for each tax shelter entered into by a person required to register.<sup>117</sup> Therefore, the penalty is calculated per tax shelter, but is imposed on the individual with the responsibility for

109. *Id.*

110. *Id.*

111. *Id.* at 443 n.3 (citing *Flora*, 362 U.S. at 175 n.38); see also *Church of Scientology of Colo. v. United States*, 499 F. Supp. 1085, 1087 (analyzing partial payments under *Flora*).

112. *Grain Belt Transp. Co., Inc. v. United States*, 1970 U.S. Dist. LEXIS 12055, \*5 (D. Kan. 1970).

113. *Id.*

114. *Flora*, 362 U.S. at 175 n.37, n. 38; *Korobkin*, 988 F.2d at 976 (citing *Boynton*, 566 F.2d at 52–53); *Steele*, 280 F.2d at 91.

115. See I.R.C. §§ 6707(a)(2), 6708(a) (2000).

116. § 6707(a)(3).

117. § 6707(a)(2).

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registering in the aggregate.<sup>118</sup>

Likewise, the section 6708 penalty is not assessed separately for each person who invested in such tax shelter, but the penalty was not included in the list required by section 6112.<sup>119</sup> It is instead calculated at \$50 per person with respect to whom there is such a failure, and is therefore divisible as such.<sup>120</sup>

It follows, that just like employment, excise, and section 6672 taxes, the section 6707 and 6708 penalties should be accepted as divisible, because their single assessment is the aggregate of amounts calculated with respect to individual tax shelters, or investors, respectively.

Divisibility of these promoter penalties is a new issue and the majority of promoter penalty cases are still in the administrative stages within the Service. Therefore, there are no reported cases dealing with their divisibility, but they are easily analogized to the penalties and taxes that are similarly assessed.

## V. CONCLUSION

This article analyzed the divisibility of I.R.C. §§ 6700, 6707 and 6708, considering and comparing taxes that are currently considered divisible, such as employment taxes, 100% penalties, and excise taxes. It then proposed that these tax shelter promoter penalties should be considered divisible for purposes of jurisdiction in federal district court. The analysis and conclusion are based on the fact that the tax shelter promoter penalties are a single assessment, composed of the aggregate of amounts calculated for each individual shelter or investor, respectively. Therefore, taxpayers assess with the sections 6700, 6706 and 6708 penalties should be allowed to partially pay before filing a refund action in federal district court or the Court of Federal Claims.

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118. § 6707(a)(3)(B).

119. § 6708(a); *see also* § 6112.

120. § 6708(a).